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RECEIVED
JAN 18 2005
PUBLIC SERVICE
COMMISSION

January 17, 2005

Beth A. O'Donnell, Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

Re: Case No. 2004-00321

Dear Ms. O'Donnell:

Please find enclosed the original and twelve (12) copies each of: 1) Gallatin Steel Company's Response to East Kentucky Power Cooperative, Inc.'s Information Requests; and 2) Gallatin Steel Company's Response to Commission Staff First Set of Data Requests filed in the above-referenced matter.

By copy of this letter, all parties listed on the attached Certificate of Service have been served. Please place these documents of file.

Very Truly Yours,



Michael L. Kurtz, Esq.
BOEHM, KURTZ & LOWRY

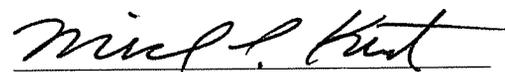
CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served by mailing a true and correct copy, by overnight mail and electronic mail to all parties on this 17th day of January, 2005.

Charles Lyle, Esq.
East Kentucky Power Cooperative, Inc.
4775 Lexington Road
P. O. Box 707
Winchester, KY 40392-0707

Mr. Bill Bosta, Manager of Pricing Process
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Michael L. Kurtz, Esq.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION OF EAST KENTUCKY)
POWER COOPERATIVE, INC., FOR APPROVAL)
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ENVIRONMENTAL SURCHARGE)

GALLATIN STEEL COMPANY'S
RESPONSE TO
COMMISSION STAFF FIRST DATA REQUESTS

1. Refer to the Direct Testimony of Lane Kollen ("Kollen Testimony"), pages 14 through 19. In this portion of his testimony, Mr. Kollen rejects the proposal by East Kentucky Power Cooperative, Inc. ("East Kentucky") that its reasonable rate of return on environmental compliance rate base should be the result of multiplying its average cost of long-term debt by a Times Interest Earned Ratio ("TIER") of 1.15X.

- a. What rate of return on East Kentucky's environmental compliance rate base does Mr. Kollen propose?
- b. Why does Mr. Kollen believe his proposed rate of return is reasonable?
- c. On page 16 Mr. Kollen notes that East Kentucky's capital structure at October 31, 2004 was 88 percent long-term debt and 12 percent equity. If Mr. Kollen proposes to use East Kentucky's average cost of long-term debt as the reasonable rate of return on environmental compliance rate base, explain why this approach would be reasonable given that East Kentucky's capital structure and capitalization includes positive equity.

RESPONSE:

- a. Mr. Kollen recommends the use of the Company's overall cost of capital, which consisted of approximately 88% debt and 12% members' equity at October 31, 2004 in the absence of project specific financing. To the extent that specific RUS or other debt financing is used on a project basis by the Company, then that should be attributed first to the Company's ECR investment. The residual investment would reflect financing at the Company's overall cost of capital, with the cost of the debt component based on the Company's actual average cost of debt (adjusted to remove any project debt financing already directly assigned to the ECR investment) and the cost of members' equity at 0%. There should be no TIER adder for the reasons provided in Mr. Kollen's Direct Testimony.
- b. The return described in part (a) of this response is reasonable because it reflects the actual costs to finance the ECR investment. It also is reasonable because it reflects no TIER adder, which is not an actual cost to finance environmental investment. The Commission addressed the issue of the TIER adder in the Company's last base rate proceeding, concluding that a margin, or TIER adder, was necessary to enable the Company to build its members' equity to 20%. Although it may be appropriate to allow the Company a margin in a base rate proceeding, there is no similar rationale that applies in an ECR proceeding. It also should be noted that the TIER adder of 15% authorized in that proceeding was based on the allowed interest expense, not an imputed interest expense assuming 100% debt financing. To the extent a TIER is allowed in the ECR, then the cumulative margin collected in this manner should be used to increase the per books members' equity in the capital structure and at a cost of 0%.

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2. Refer to page 21 of the Kollen Testimony. Mr. Kollen argues that the Commission should not accept East Kentucky's proposal to recognize a full month's depreciation expense on environmental plant regardless of the in-service date during the month. To the extent Mr. Kollen knows, does East Kentucky's proposed accounting approach for depreciation expense reflect the normal approach followed by regulated utilities when new utility plant is placed in service? Explain the response.

RESPONSE:

Mr. Kollen is familiar with the accounting practices of the Entergy operating utilities. Those utilities do not recognize any depreciation expense on plant additions in the month of service. Instead, those utilities recognize a full month of depreciation in the first month following the month of service.

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3. Refer to pages 23 and 24 of the Kollen Testimony. On lines 9 through 13 of page 23, Mr. Kollen describes the base-current methodology as authorized for the environmental surcharge mechanisms used by Louisville Gas and Electric Company and Kentucky Utilities Company. However, the approach Mr. Kollen cites from the Big Rivers Electric Corporation environmental surcharge Order is similar to the base-current approach authorized for the environmental surcharge mechanism used by Kentucky Power Company. Which variation of the base-current approach does Mr. Kollen recommend for East Kentucky's environmental surcharge mechanism? Explain the response.

RESPONSE:

Mr. Kollen believes that the base-current approach adopted for LG&E and KU in conjunction with the ECR roll-in to base rates is the superior approach because it properly captures growth in revenues over time.

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4. Refer to pages 26 through 29 of the Kollen Testimony. Mr. Kollen explains why steam sales revenues from Inland Container ("Inland") and a portion of the revenues from Tennessee Gas Pipeline ("TGP") and Gallatin should be included in the determination of the R(m) revenues.

- a. Does Mr. Kollen recommend that Inland should be billed an environmental surcharge for both its electric and steam sales? Explain the response.
- b. Does Mr. Kollen recommend that TGP should be billed an environmental surcharge based on the bill for the East Kentucky-generated energy sold to TGP? Explain the response.
- c. Does Mr. Kollen recommend that Gallatin should be billed an environmental surcharge based on the bill for the East Kentucky-generated energy sold to Gallatin? Explain the response.
- d. If Mr. Kollen believes that Inland, TGP, or Gallatin should not be billed any environmental surcharge, explain in detail why it would be appropriate to include the revenues in the determination of the R(m) revenues used in the environmental surcharge mechanism, as proposed by Mr. Kollen.

RESPONSE:

- a. No. The Commission does not have jurisdiction to direct that the environmental costs allocated to Inland actually be billed to Inland. Such an allocation of costs to non-jurisdictional revenues has been applied by the Commission in all other ECR surcharge authorizations.
- b. Yes. This is a matter of law and allocation of costs based on the principle of cost causation.
- c. Yes. This is a matter of law and allocation of costs based on the principle of cost causation. However, Gallatin should not be billed an environmental surcharge on the energy purchased from LG&E to serve Gallatin since EKPC incurs no environmental expense on such purchases.
- d. Please refer to the responses to parts (b) and (c) to this request.

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5. For each of the items listed below relating to East Kentucky's proposed environmental surcharge mechanism, indicate if Mr. Kollen has any comments or recommendations and provide the comments or recommendations.

- a. The treatment of the proceeds from the sale of Gilbert unit by-products of fly ash, bed ash, and scrubber particles.
- b. The reasonableness of the depreciation rates used by East Kentucky to determine the depreciation expense to be included in the environmental surcharge mechanism.
- c. The use of a 12-month rolling average expense for operation and maintenance expenses ("O&M expenses") and air permit fees included in the environmental surcharge mechanism.
- d. The use of a 1993 baseline of O&M expenses in the environmental surcharge mechanism.
- e. East Kentucky's proposal to accumulate the monthly environmental surcharge over- or under-recoveries during the six-month period and apply these recoveries prospectively over the next six-month period.
- f. The inclusion of the estimated cost of SO₂ emission allowances in the SO₂ emission allowance inventory included in the environmental surcharge mechanism.
- g. The treatment of the proceeds East Kentucky receives from the annual Environmental Protection Agency's auction of withheld SO₂ emission allowances
- h. East Kentucky's proposal to reset the rate of return on its environmental surcharge compliance rate base every six months, outside of a six-month environmental surcharge review.
- i. East Kentucky's proposal to design the pass through of the environmental surcharge to cooperative member systems' retail customers in such a way as to eliminate a one-month lag in the billing process.

RESPONSE:

- a. Proceeds from the sale of by-products should be used to reduce the ECR revenue requirement consistent with prior Commission decisions.
- b. Mr. Kollen has no opinion on this issue.
- c. Mr. Kollen believes that current cost means the actual current monthly cost, but does not believe that use of a twelve month average, subject to true-up, violates this principle.
- d. Mr. Kollen believes that a base-current approach to remove the costs already recovered in existing rates is a superior approach to the incremental approach if it recognizes revenue growth since the base year.

- e. Mr. Kollen believes that this is reasonable, particularly if the Company's proposal for use of a rolling twelve month average of O&M expenses and estimated costs of allowances are authorized. In this manner, a true-up to actual is ongoing and timely.
- f. Mr. Kollen does not believe that the estimated costs should be used in lieu of actual costs when incurred. Nevertheless, this is not a significant problem as a practical matter to the extent that the estimated costs are trued up to actual within a reasonable period of time.
- g. The allowances from the annual EPA auction either should be included in inventory at \$0 cost and used by EKPC or sold at market and credited to the ECR costs.
- h. Mr. Kollen does not oppose this proposal, assuming that actual costs are utilized.
- i. Mr. Kollen does not oppose this proposal.

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6. Refer to East Kentucky's responses to the Commission Staffs Third Data Request dated December 10, 2004, Items 4 and 7. East Kentucky has stated its belief that it is necessary to mitigate fluctuations in the calculation of the environmental surcharge factor for the benefit of its member systems and the member systems' retail customers. East Kentucky has further stated that minimizing the fluctuation of the monthly environmental surcharge on its customers is more significant than the timing of any cost recovery. Does Mr. Kollen have any comments or recommendations concerning these expressed positions of East Kentucky? If yes, provide the comments or recommendations.

RESPONSE:

EKPC's overall position on this is reasonable. However, I do not agree that minimizing the monthly fluctuation is more significant than the timing of cost recovery.

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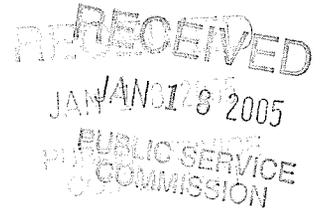
7. Refer to East Kentucky's response to Gallatin's First Data Request dated November 19, 2004, Item 3, the attachment to the response. East Kentucky has stated that the rate of return on environmental compliance rate base it used in this response was the result of multiplying the 1993 year-end average cost of debt by a TIER of 1.15X. East Kentucky has indicated that it believes the calculation of the base period environmental surcharge factor ("BESF") should be consistent with the calculation of the current period environmental surcharge factor ("CESF")

- a. Does Mr. Kollen agree that the rate of return on environmental compliance rate base East Kentucky used in its original response to Gallatin is appropriate? Explain the response.
- b. In Case No. 1994-00336,¹ the Commission determined that revenues based on a TIER of 1.15X would result in a rate of return on rate base of 8.41 percent. In this case, when determining the BESF under the base-current methodology, does Mr. Kollen believe it would be appropriate to use a rate of return on environmental compliance rate base of 8.41 percent? Explain the response.
- c. Does Mr. Kollen agree with East Kentucky's statement that the calculation of the BESF should be consistent with the calculation of the CESF? Explain the response.

RESPONSE:

- a. No. The Case No. 94-336 Order stated that the reduction in revenue authorized by the Commission in that proceeding "will result in a 8.41 percent rate of return on net investment rate base. As such, the BESF factor should be computed using the 8.41% rate of return, not the cost of long term debt with a 15% TIER adder as detailed on page 2 of 4 of the Attachment to the Company's response to Gallatin 1-3.
- b. Please refer to the response to part (a) of this request.
- c. Mr. Kollen was unable to locate a statement by EKPC to that effect and does not know the context of the statement. Although Mr. Kollen does not disagree with the principle, he may disagree with specific applications of the principle.

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INFORMATION REQUESTS

1. Regarding Mr. Kollen's statement on page 4 of his Direct Testimony that the Kentucky Public Service Commission (the "Commission") has only approved Compliance Plans pursuant to KRS §278.183 which apply to "coal combustion wastes and by-products from facilities utilized for the production of energy from coal".
 - a. Does Mr. Kollen acknowledge that KRS §278.183 identifies two categories of environmental compliance costs that are eligible for recovery, those relating to "the Federal Clean Air Act as amended", and costs relating to "those federal, state or local environmental requirements which apply to coal combustion wastes and by-products from facilities utilized for the production of energy from coal"?
 - b. Does Mr. Kollen contend that there is no distinction between these two categories of eligible environmental compliance costs referenced in KRS §278.183? If so, how does Mr. Kollen explain the statute's specific reference to the Federal Clean Air Act as amended, if the requirements of that Act are encompassed in the second category of compliance costs referenced in KRS §278.183?
 - c. If Mr. Kollen recognizes compliance costs of the Federal Clean Air Act, as amended, as a distinct category of eligible costs under KRS §278.183, please identify any language in the statute which limits the recovery of such costs to those associated with coal-fired generating units.

RESPONSE:

- a. No. Mr. Kollen believes there is only one category of costs, those related to "costs of complying with the Federal Clean Air Act as amended and those federal, state or local environmental requirements which apply to coal combustion wastes and by-products from facilities utilized for production of energy from coal in accordance with the utility's compliance plan as designated in subsection (2) of this section."
- b. Yes. Please refer to response to part (a) of this request.
- c. Please refer to response to part (a) of this request.

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2. Regarding Mr. Kollen's statement on page 9 of his Testimony that KRS §278.183 does not provide for recovery of environmental costs incurred at gas generating units:
- a. Does Mr. Kollen acknowledge that the Federal Clean Air Act, as amended, contains provisions that impose environmental compliance costs on gas-fired electric generating units?
 - b. Does Mr. Kollen agree that EKPC's NOx control equipment, included in its Application in this case, is required in order to comply with requirements of the Federal Clean Act, as amended?
 - c. Please identify any orders of the Commission in which such costs were excluded from recovery under an environmental surcharge approved pursuant to KRS §278.183, and provide copies of such orders.
 - d. Please identify any orders of the Commission which state that environmental compliance costs of gas-fired generating units cannot be recovered pursuant to KRS §278.183, and provide copies of such statements.
 - e. Please identify any case law authority which would prohibit a ruling by the Commission allowing the recovery of such costs pursuant to KRS §278.183, and provide copies of such authority.

RESPONSE:

- a. Yes.
- b. Yes.
- c. Mr. Kollen is unaware of any Commission Orders that specifically approved or addressed the recovery of compliance costs related to gas-fired generation.
- d. Please refer to response to part (c) of this request.
- e. Object. KIUC is not obligated to perform legal research for the Company.

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3. Regarding Mr. Kollen's testimony at Page 15, where he states: "To be "reasonable" a cost must be incurred. The TIER adder is not an incurred cost, but rather an imputed margin above cost at best. To be "reasonable," the cost must be an "actual" and "current" cost of compliance. The TIER adder is neither."
 - a. Please identify any orders of the Commission which state that a reasonable return on environmental facilities, recoverable under KRS §278.183, cannot include a margin above cost, and provide copies of such statements.
 - b. Please identify any orders of the Commission which state that a reasonable return on environmental facilities, recoverable under KRS §278.183, must be determined by a different standard than would be applied to set a reasonable return on such facilities in a base rate case, and provide copies of such statements.

RESPONSE:

- a. To Mr. Kollen's knowledge, the Commission has never authorized a margin above cost for recovery of environmental costs pursuant to KRS §278.183.
- b. The standard for environmental surcharge recovery is KRS §278.183. That statute does not address recovery in a base rate proceeding. The Commission has applied KRS §278.183 in each of the ECR proceedings and other appropriate statutory standards in base rate proceedings.

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4. Has Mr. Kollen ever filed testimony on cost of capital issues in any regulatory proceeding? If so, please provide copies of the testimony as well as the portion of the Commission Order in the proceeding dealing with the cost of capital issue.

RESPONSE:

Yes. Copies of relevant testimonies are being provided to the requesting party. Orders are publicly available and can be researched by the requesting party.

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5. Has Mr. Kollen ever filed testimony regarding TIER requirements in a regulatory proceeding involving Cooperatives? If so, please provide copies of the testimony as well as the Commission order dealing with the TIER requirement issue.

RESPONSE:

Yes. Copies of relevant testimonies are being provided to the requesting party. Orders are publicly available and can be researched by the requesting party.

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6. Reference Page 15 of Mr. Kollen's testimony where Mr. Kollen states that a TIER of no more than 1.0X is warranted in this proceeding. Would Mr. Kollen agree that the interest expense associated with the environmental assets already included in EKPC base rates was subject to a 1.15 X adder?

RESPONSE:

Yes.

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7. Please list the factors used by the Commission in determining a "reasonable return" under the surcharge statute for those utilities that have been awarded such a return. Please provide copies of the Orders which define these factors.

RESPONSE:

For Big Rivers, during the time period in which it had an ECR surcharge, the Commission utilized a debt only rate of return, with no adder, on all environmental projects. Big Rivers had negative members' equity. For LG&E and KU, the Commission has utilized a PC debt only rate of return, with no adder, for certain environmental projects and an overall rate of return for all other environmental projects. For KPC, the Commission has utilized an overall rate of return, with no adder, for all environmental projects. For LG&E, KU, and KPC, in the determination of the overall rate of return, the Commission has utilized the utilities' actual capital structure to weight the costs of the components of the rate of return. It also has used the average actual cost rates for each component except common equity. For common equity, the Commission has used a reasonable rate of return based on the evidence presented in each proceeding. The Commission's rationale for the use of these various rates of return, including the reasonable rate of return on common equity, is described in the relevant Commission Orders. These Orders are publicly available and can be researched by the Company.

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8. Does Mr. Kollen agree that the Commission did not explicitly deny an increment for a TIER adder for Big Rivers in Case No. 94-032?

RESPONSE:

Yes. Big Rivers did not request a TIER adder, nor would one have been appropriate.

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9. Does Mr. Kollen agree that the reasonable return approved by the Commission for the environmental surcharges for Kentucky Power, Kentucky Utilities and Louisville Gas & Electric are rates based on the overall cost of capital including debt and equity?

RESPONSE:

Yes, at least in part. If that same standard were applied to EKPC, then the debt ratio would be 88% and the members' equity ratio would be 12% as of October 31, 2004. As noted by Mr. Kollen in his Direct Testimony, EKPC's request assumed that its ECR investment was financed by 100% debt rather than its overall cost of capital. If the Commission determines that the ECR investment was financed by the actual overall cost of capital, then the Company's request should be reduced further than recommended by Mr. Kollen. The interest should be computed using the actual percentage debt in the capital structure, thereby reducing the interest component of the Company's request by approximately 12%.

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10. Please state whether EKPC's use of a full month of depreciation expense for plant additions occurring within that same month is in conformance with Generally Accepted Accounting Practices (GAAP).

RESPONSE:

Generally Accepted Accounting Principles may allow for a range of depreciation practice, including a full month of depreciation, a pro-rated amount, or none whatsoever in the month an addition is placed in-service. However, GAAP does not control ratemaking and it is not reasonable for a full month of depreciation expense to be included in a surcharge unless the asset provided a full month of service.

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11. Please provide the names of all electric utilities subject to the jurisdiction of this Commission and known to Mr. Kollen who prorate the first month of depreciation expense for any new plant additions including approved Compliance Plan projects under KRS §278.183.

RESPONSE:

Mr. Kollen does not know how the other electric utilities subject to the jurisdiction of this Commission recognize depreciation. Mr. Kollen does know that the Entergy operating utilities do not compute any depreciation for the month of the plant addition, regardless of the date in service. The Entergy operating companies then compute a full month of depreciation for the month following the in-service month. That also was the practice at The Toledo Edison Company when Mr. Kollen was employed by that Company and worked in the Property Accounting and Tax Accounting departments.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

**THE APPLICATION OF EAST KENTUCKY)
POWER COOPERATIVE, INC., FOR APPROVAL)
OF AN ENVIRONMENTAL COMPLIANCE PLAN) CASE NO. 2004-
AND AUTHORITY TO IMPLEMENT AN) 00321
ENVIRONMENTAL SURCHARGE)**

**GALLATIN STEEL COMPANY'S
RESPONSE TO
EAST KENTUCKY POWER COOPERATIVE, INC.'S
INFORMATION REQUESTS**

12. Would Mr. Kollen agree that if the Commission approves a full month of depreciation expense for any new plant addition that such expense is an actual recoverable cost under KRS §278.183?

RESPONSE:

Yes.

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13. Please provide the names of all electric utilities and Orders, including Orders from environmental surcharge cases, where this Commission has directed the utility to prorate the first month of depreciation for a new plant addition.

RESPONSE:

Please refer to the response to Item 11 of this Set of Data Requests.

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14. Does Mr. Kollen agree that the statute permits the recovery of eligible current environmental compliance costs not already included in base rates?

RESPONSE:

Yes.

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15. Is it Mr. Kollen's testimony that the Commission should approve a BESF of 0.57% in this proceeding?

RESPONSE:

No. The Company's computation of this percentage factor, provided in response to Gallatin 1-3, appears to be inconsistent with the Commission's determination in that Order that the "reduction in revenue will result in a 8.41 percent rate of return on net investment rate base."

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16. Reference Mr. Kollen's testimony at Page 29, lines 14-15. Please provide the basis for the assertion that the "Commission has found that R(m) should include revenues from off-system sales". Is Mr. Kollen referring to the adjustment made to E(m) for recognition of off-system sales? Please provide excerpts from Commission orders that address this issue.

RESPONSE:

Mr. Kollen referred to R(m), which is the monthly average of total Company revenues excluding ECR revenues. The Commission has included non-jurisdictional revenues, including off-system sales, in R(m) for the other jurisdictional utilities with ECR surcharge riders. For example, in Case No. 93-465, KU's initial ECR surcharge proceeding, the Commission adopted a reporting format that showed the development of the total Company revenues with separate reporting of Kentucky jurisdictional revenues and non-jurisdictional revenues (Form ES 3.0).